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If the monetary institutions offer their money or their credit on abnormally favourable terms, this must logically lead to intensified use of money or credit on the part of the public. A rise in prices is the result, and we have seen that prices will continue rising so long as credit remains easy. A tightening of credit has, of course, the opposite effect.

The supply of real capital is limited by pure physical conditions, while the supply of money is in theory unlimited and even in practice is held within fairly elastic boundaries.

— Knut Wicksell, *Interest and Prices*, 1898

BORROWING FROM THE FUTURE

It is now fully 14 months since the Greenspan team at the Federal Reserve started its rate hikes at a very "measured pace." Its short-term federal funds rate is up 250 basis points altogether, from 1% to 3.5%. If it were their intention, as we assume, to exert no restraint at all on borrowing, they have fully achieved this goal.

Notoriously, yields of 10-year Treasury notes, the benchmark rate for the long-term area, fell by 50 basis points over this period, from 4.7% to 4.2%, and sometimes lower. Yet looking for restraint, the critical aggregate is credit expansion. It has gone through the roof.

Bank credit has expanded $544.7 billion year to date, or 13.5% annualized. Among this total, security credit gained $145.6 billion, up 12.7% annualized. Commercial and industrial loans have surged at an annualized rate of 18.8%. Real estate loans are up at an annualized rate of 16.7%. Year to date, asset-backed securities (ABS) issuance is up $451 billion, i.e., 21% ahead of comparable 2004. Home equity loan ABS issuance of $286 billion is 24% above its growth in 2004's same period.

Compare these stellar growth rates of credit with the reported real GDP growth of 3.6% annualized during the first half of 2005. Credit and debt is growing out of any reasonable proportion to real GDP. We hasten to repeat our regular proviso that owing to grossly understated inflation rates, we regard these reported growth rates as grossly overstated.

Another disquieting counterpart to this credit insanity is the protracted, sharp slowdown in money growth. M3 is up 5.4% at annualized rate over the last six months, and M2 only 2.3%.

Normally, credit and money grow together. But two things disrupt this connection: the huge and rising import surplus and the escalating Ponzi finance. Soaring interest expenses are increasingly met with new credit. What keeps the national Ponzi scheme going is the common illusion that rising asset prices are creating wealth.

And there is still another critical point to see. While household holdings of liquid assets keep rising, they are collapsing in relation to outstanding debts and holdings of illiquid assets. The liquidity preference of private households is apparently deep in negative territory but is eagerly accommodated by banks and other lenders.

It is our long-held conviction that the U.S. economy has entered a new slowdown, as the prior massive monetary and fiscal stimulus has petered out. There is nothing in sight to generate self-sustaining growth. Essentially, this would have to be a capital-spending boom big enough to take over for the housing bubble. But that is totally out of the question.

Several major economic data have recently surprised on the positive side. On closer look, we note that both the Bureau of Economic Analysis and the Bureau of Labor Statistics have recently become unusually aggressive in bending figures to show desired results.

In the *New York Post* of Aug. 7, 2005, John Crudele argued that the reported 207,000-job gain in July was heavily fabricated through a change in seasonal adjustment. From statistics expert John Williams of *Shadow Government Statistics* we received the following details:

Unadjusted payrolls usually drop off sharply in July, so heavy seasonal adjustment is needed to balance the picture. In July 2004, an actual job loss of 1.143 million translated through seasonal adjustment into a job gain of 83,000. In July 2005, however, a higher job loss of 1.201 million translated mysteriously into 207,000 new jobs. According to Mr. Williams, the same seasonal adjustment as in the prior year would have resulted in 44,000 new jobs.

A MOST UNUSUAL GDP MIX

As to be expected, the two official statistical agencies managed to deliver a rate of real GDP growth for the second quarter that the bullish consensus wanted and liked. As reported, it rose at an annual rate of 3.4%, though slightly less than the consensus forecast of 3.5%.

Our first look was at the GDP price deflator, which determines the inflation adjustment of nominal GDP. It was 2.4% at annual rate, down from a 3% rate in the first quarter. Absent this decline, real GDP would have grown by 2.8%. Meanwhile, the deflator for personal consumption was reported at 3.3% at annual rate, up from 2.9% in the prior quarter. Fortunately, this inflation rate does not affect GDP. If so, GDP growth would have been close to 2.5%.

Next to strike us was a drastic change in the mix of GDP growth. The predominant negative was a large subtraction on account of inventories; the predominant positive was a large addition from soaring net exports.

The big subtraction on account of inventories immediately kindled the fantasy of economic forecasters. *The Wall Street Journal* commented:

> *Most economists looked past the weaker headline… and focused on measures of inventory accumulation that indicated companies aggressively reduced their stockpiles in the second quarter. Shaken by concerns about an economic "soft spot" early in the year, companies cut inventories at a seasonally adjusted annual rate of $10 billion, not adjusted for inflation. It marked the largest inventory reductions since the waning days of the recession. The reductions reduce output in the current quarter but put many companies in a position to increase output in coming months.*

Actually, the inventory component subtracted 2.32 percentage points from real GDP growth. Absent a compensating sharp growth in other components, it would have slashed the growth rate to a miserable 1.08%, and that annualized. Imagine the stupefaction that such news would have evoked among people and markets. It could not be allowed to happen.

THE EXPORT CONUNDRUM

The savior was an astoundingly big contribution from net exports, equal to 1.57 percentage points of the reported real GDP growth. Remembering no such dramatic improvements in the trade data reported earlier, we took a close look.

In current dollars, exports of goods and services had increased $49.3 billion during the quarter, while imports had risen $31.7 billion. This produced a net export surplus of $17.7 billion for the quarter, as against GDP growth of $177.4 billion (all in current dollars).

But inflation adjustment converted this rather modest contribution in nominal terms into a virtual export outburst of $44.1 billion in chained dollars, and this against GDP growth of $92.7 billion. In current dollars, the net export surplus accounted for just 10% of GDP growth. In chained dollars, it contributed 47.5%, almost five times its share in GDP growth.

Clearly, this one component made all the difference for the reported GDP growth. A difference of such stupendous size between the two measures would, in our view, oblige the Bureau of Economic Analysis to

explain. In essence, it must reflect a whopping inflation adjustment, but there is no indication of it in the published indexes.

THE PRODUCTIVITY CONUNDRUM

In the last letter, we contended that salient growth of GDP and productivity is worthless when it does not show in corresponding income growth, as is presently the case in the United States. GDP measures final expenditures. Gross domestic income measures income earned in the production of GDP. In concept, both should be equal. In practice, they generally differ, because they are calculated differently.

In the United States, though, the difference between them has become grotesque. In the second quarter of 2005, a reported annualized growth rate for real GDP compared with a miserable growth rate of 1.4% for real disposable income of private households.

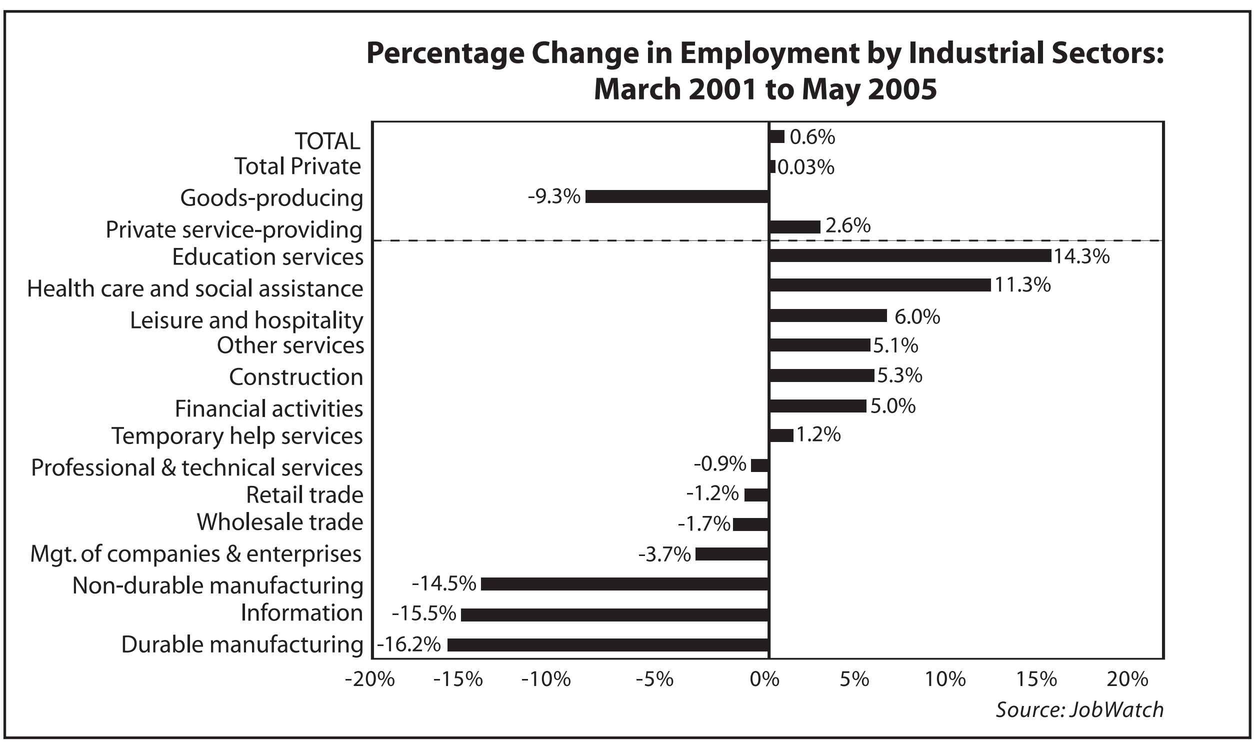
After recent downward revisions, U.S. real GDP over the four years 2000–04 has grown 9.56%. Real GDP, to recall, is the aggregate from which the Bureau of Labor Statistics derives its productivity numbers. Labor productivity — output per hour of all persons in the nonfarm business sector — soared by 16% over these four years.

For sure, productivity numbers are of enormous psychological importance, being customarily taken as a proxy for an economy's efficiency and rising living standards. Beyond any question, the stellar U.S. productivity numbers as reported over the last few years have played a big role, nationally and internationally, in creating the image of a superior U.S. economic performance. Nobody takes issue with the fact that those splendid productivity numbers diametrically conflict with a myriad of other numbers.

Until the late 1970s, real wage and salary growth in the United States in real terms had perfectly matched reported labor productivity growth, as they should. But since the 1980s, they increasingly diverged, and since 2000, they have been grotesquely out of whack. While productivity growth has since surged by 16%, or 4% per year, "average gross weekly earnings measured in 1982 dollars" have inched up from $275.38 to $277.19; i.e., by 0.6%, or 0.15% per year. Of course, the latter is the reality.

There ought to be outcries for an explanation.

In the end, there is a single reasonable explanation. The productivity numbers are the same baloney as the



real GDP numbers from which they derive. Both are heavily inflated by understated inflation rates, but the reported productivity growth seems to benefit also from cheap imports.

Yet there is still another reason why we regard the reported productivity miracle as outright preposterous. That is the striking shift in the U.S. economy's output and growth structure, described by us as "downward restructuring." Expressed in the parlance of Austrian theory, it is a shift "toward less capitalistic production." Putting it bluntly: Expanding services with low-paying jobs contrasts with drastic job destruction in the high-paying manufacturing sector.

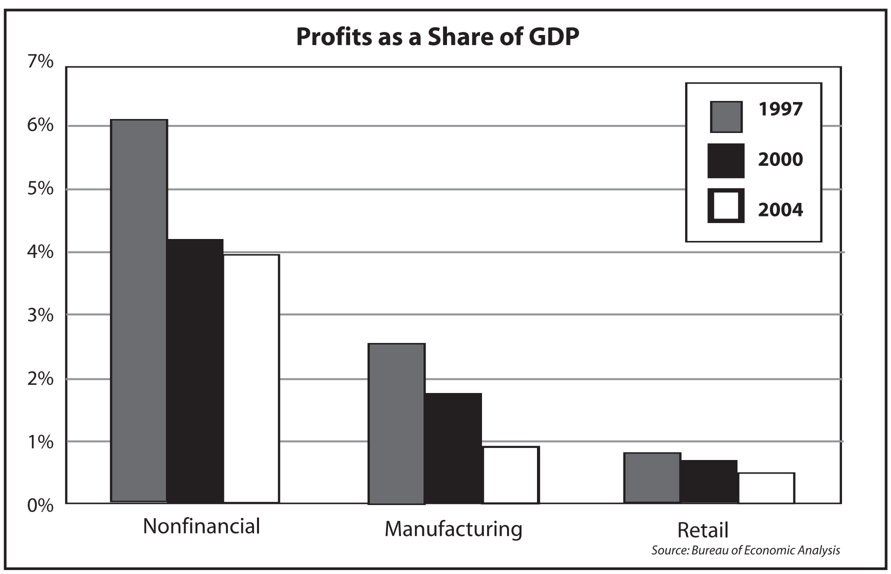
THE PROFIT CONUNDRUM

According to conventional reports, U.S. businesses have fabulously boosted their profits during the past few years. Have they really? It depends from where you measure. If you measure from their recession low, profits have sharply recovered. If you measure over a longer period, they are performing very poorly.

Our own assessment starts with 1997 as the year in which U.S. profits peaked after a long, strong recovery from their low in the early 1990s. First of all, we have to point out that over those seven years, U.S. businesses enjoyed two major benefits for their profits. First, their labor costs per unit of output fell 28%, and their sales prices increased by 18%. On top of that, they profited immensely from the steep falls in interest rates.

But where is the profit bonanza to be expected under these conditions? For the nonfinancial sector, profits amounted to $508.4 billion in 1997, to $409.8 billion in 2000 and to $534.2 billion in 2004. This makes for an overall increase by $25.8 billion, or 0.5%, for the seven years. As a share of GDP, profits have steeply declined.

Again, the devil is in the details. Another most important point to recognize is the wide divergence in profit performance between different sectors of the economy. Take a look at the table on the next page.



Please note the last item in this table: rest of the world. It captures the profits earned by the foreign subsidiaries of U.S. companies. In contrast to domestic earnings, these are up, up and up.

Two features in the table on the next page strike the eye. The one is the diametric divergence in the profit performance between the financial and nonfinancial sectors. Playing the steep yield curve, financial firms could virtually print profits. It goes without saying that many nonfinancial firms also knew to exploit this curve.

The other most striking and also most important feature is the profit performance of the durable goods sector of manufacturing. Here, profits have literally collapsed across the board. In general, this appears to reflect protracted weakness in business fixed investment and a corresponding lack of pricing power. A different, most ominous case is certainly the auto industry, considering that for years it has been running losses, despite booming sales.

THE TWO CRITICAL DRAGS

Recently, Stephen Roach of Morgan Stanley wrote, *"There's good growth and bad growth. The former is well supported by internal income generation and saving. The latter is driven by asset bubbles and debt."*

U.S. PROFIT PERFORMANCE 1997–2004 (IN $BILLION)

	1997	2000	2001	2002	2003	2004
Financial	193.0	200.2	227.6	276.3	299.8	294.0
Nonfinancial	508.4	413.4	322.0	322.8	383.6	456.4
Manufacturing	209.0	144.3	52.6	48.2	80.7	118.9
Durable goods	103.1	60.0	–25.4	–9.9	–4.1	34.8
Machinery	16.7	8.2	2.7	1.7	1.4	1.0
Computer and electronic products		4.0	–48.5	–35.3	–16.1	–3.2
Electrical equipment	6.1	5.6	1.9	–0.1	1.9	0.3
Motor vehicles	4.8	–1.0	–9.2	–5.0	–11.6	–3.4
Nondurable goods	105.9	84.3	78.0	58.9	70.7	82.2
Retail trade	64.2	59.6	71.0	78.1	77.7	72.2
Rest of the world	110.9	145.7	169.7	157.8	176.9	192.0

Source: National Economic Accounts, Bureau of Economic Analysis

Putting it more precisely: Sustainable *good* growth is well supported by saving, investment, employment and income generation. Unsustainable *bad* growth is driven by asset bubbles and an associated debt binge propelling consumer spending at the expense of saving, investment and net exports.

The emphasis here is on the second part of the sentence — *"propelling consumer spending at the expense of saving, investment and net exports."* It pinpoints the structural damages, which the equity and housing inflation and the associated consumer borrowing-and-spending binge have been inflicting on the U.S. economy for more than 10 years.

As we have repeatedly stressed in past letters, the U.S. economy's performance since 2000, when its long expansion suddenly broke, appears in a very favorable light if you choose real GDP as the key measure and compare its growth rates with the lower ones in Japan and most of Europe.

But when you broaden the measure of performance to employment and associated income growth and draw comparisons with the prior cyclical upswings, this U.S. recovery comes out as the poorest in the whole postwar period by far. Its cause or causes are essentially the first important question.

Macroeconomic analysis distinctly reveals two factors that are mainly responsible for this poor growth performance: the soaring trade deficit and lagging business fixed investment. Further analysis indicates one common cause. Put briefly and bluntly: Both are being crowded out by the inordinate consumer borrowing-and-spending binge.

As consumption has been taking a growing share of GDP, this protracted pressure of "consumption excess" is pulling resources away from capital investment and the foreign trade sector, resulting in soaring imports and lagging exports.

Appreciating the enormous size of these two major structural maladjustments and their dire implications for the economy's present and future growth performance, it is a compelling conclusion for us that the normal, self-sustaining economic recovery, as was the rule in the past, is completely out of the question under these conditions for the United States.

MACROECONOMICS REWRITTEN

We realize that this assessment diametrically contrasts with the general, unconcerned evaluation prevailing

in the United States and probably around the world. American policymakers and conformist economists revel, rather, in the conviction that U.S. monetary policy has become more efficient by primarily targeting wealth creation through rising asset prices. Pointing to the fudged high growth rates of real GDP and productivity, they even claim extraordinary success.

Nobody claims this louder and more persistently than Mr. Greenspan. Never before has there been a central banker so eager to spin a glaring impression about his policies and their result. Claiming the irrelevance of zero savings and of a huge trade deficit, the Fed has led the charge in rewriting macroeconomics in order to convince the public and market participants of the wisdom of its unusual new policies.

Amazingly to us, these fantastic claims are sparking neither any debate nor challenge from leading economists, although these questions are of the greatest importance in assessing the U.S. economy's outlook.

With their silence, they seem to agree. There is a general, firm view that rates of inflation and rates of economic growth are the most relevant indicators of economic health. This, actually, has been the fundamental pattern of economic thinking in the United States since Wesley Mitchell's *Business Cycles* (1913) presented a low inflation rate as the key test for sound economic performance.

Observing fairly high rates of economic growth in coincidence with reported low rates of inflation, the consensus takes this is as compelling proof of the U.S. economy's excellent shape, guaranteeing further economic growth around its trend line as far as the eye can see.

Actually, there is a fatal precedent to this misapprehension. That is the New Era of the 1920s.

Then, too, prolonged stability of the price level blinded policymakers and most economists to the excesses in the credit system and the developing structural disproportions in the economy.

THE TRUTH: WEALTH EROSION

Earlier, we spoke of lagging business fixed investment as one critical drag on the U.S. economy's current recovery. But there is a second aspect of overriding importance to business investment. That is its decisive role in wealth creation.

The following remark by economist J.M. Keynes states what used to be a banality for economists and any reasonable person: *"It is investment, i.e., the increased production in material wealth in the shape of capital goods, which alone increases national wealth."*

For the old economists, national wealth creation had one single possible source, i.e., capital accumulation through saving and investment. It was another truism in economics to strictly distinguish between such real wealth creation and changes in the valuation of existing property, including plant, equipment, buildings and all sorts of financial assets, such as bonds, stocks, etc., taking place entirely outside the economy in the markets.

This strict distinction had an obvious reason: Mere price increases of assets have no direct economic effect. Wealth creation through saving and investment has cumulative self-sustaining spending and income effects far into the future. There is really no comparison between the two. Principally, wealth increases when the community produces more than it consumes. Conversely, wealth decreases when the community consumes more than it produces.

Manifestly, the latter is true at enormous scale for the United States. For many years now, consumption has significantly exceeded overall production. Its striking counterparts, as explained earlier, are the soaring foreign debts, reflecting the escalating trade deficit and diminished domestic capital investment. The true name of this game is national impoverishment.

ILLUSION AND DELUSION

American economists have never been as strict as European economists in making this distinction in wealth creation between rising market valuations and rising capital stock through saving and investment. Yet what has

happened lately in this respect puts economic reason on its head. Protracted house price inflation, deliberately engineered by the Fed, is presented to the public as a virtually wondrous new policy stance in creating wealth and economic growth.

It is hard to believe that such a grotesque perception is possible. But among our files is an article from an American professor, John C. Edmunds, published in 1996 in *Foreign Policy* under the title, "Securities: The New World Wealth Machine." On its first page, it says:

> *Historically, manufacturing, exporting and direct investment produced prosperity through income creation. Wealth was created when a portion of income was diverted from consumption into investment in buildings, machinery and technological change. Societies accumulated wealth slowly over generations. Now many societies, and indeed the entire world, have successfully learned how to create wealth directly. The new approach requires that a state find ways to increase the market value of its stock of productive assets. Several countries have successfully directed their economic policies toward that goal, achieving and sustaining faster growth rates than once were thought possible.*

First of all, it is by no means happening in the *"entire world."* Economic thinking of this kind and the explicit corresponding policies are the particularity of the Anglo-Saxon countries. Even among them, however, the United States stands out with its unreserved glorification of this development.

Manifestly, nothing happens in the economy. The reality is rising asset values through a stroke of the pen, owing to the conventional practice in some countries to regard the prices of all existing houses as being worth the price of the last trade, however small the trade may be in relation to the overall stock. Inherently, this practice applies immense, totally unreasonable leverage to the appearance of wealth in a country.

We understand that people facing a falling living standard from their current income readily grasp at this illusion. But for policymakers and economists to foster this illusion is irresponsible, deliberate deception.

Yet the idea that reasonable people, let alone leading policymakers and economists, can truly believe in such economic balderdash is flatly inconceivable to us. Our own interpretation is that in 2001, facing the collapsing stock market, the Fed slashed its interest rate in a panic.

Observing, then, the surging housing bubble and the correlated credit-consumption bubble, they rationalized and systematically extended it, pronouncing a virtuous new monetary policy strategy.

CONSUMER-LED VS. INVESTMENT-LED GROWTH

All it needs to understand the folly of this monetary policy is a comparison with the old-fashioned wealth creation through saving and investment. The key point to see, as we have repeatedly stressed, is that borrowing for investment implicitly initiates a long, self-sustaining sequence of employment and income effects far into the future.

In its first round, investment spending creates employment and consumer incomes through the production of the capital goods. In the second round, the installed plant and equipment create new employment and incomes through their productive activity. All this activity, moreover, is self-financing in the long run through depreciations and their reinvestment.

It is the great fallacy in conventional American economic thinking that consumer spending can replace investment spending and that consumption-led growth's economic effects are on the same footing as investment-led growth.

As the actual development in the United States and other countries over the past several years shows, the two produce totally different growth patterns with radically different effects on employment and incomes.

Common to all the countries driven by housing bubbles and associated consumer borrowing-and-spending binges are four dismal macroeconomic hallmarks: sliding savings, rising trade deficits, exploding consumer debts and an increasing share of consumption in their GDP.

The key features of investment-led economies are high rates of saving, chronic export surpluses, moderate

debt growth and a persistently high share of investment in GDP. This pattern used to be true, to different degrees, of all industrialized countries. Germany and Japan had savings and investment rates on the high side. America's rates of saving and investment were always on the lower side in relation to these countries.

Ultimately, these differences in effects between the two growth components have their cause in one key difference. Consumer spending only creates demand; investment spending creates both demand and supply in one sweep.

Yet capital investment, too, can become excessive, as Japan has learned the hard way. We wondered for some time whether the Chinese authorities are determined to follow Japan's disastrous example.

Arithmetically, the United States has been enjoying its most prodigious wealth creation in the postwar period over the past few years, overwhelmingly derived from rising house prices. According to the Fed's flow of funds statistics, housing values have jumped by $6.3 trillion, or 55%, since 2000. As home mortgages rose "only" $2.9 billion, owners' equity ballooned.

In the consensus view, this wealth creation is the Fed's outstanding achievement. But what is this kind of wealth creation doing for the future? In reality, it borrows future income, assuming that debts have to be repaid. Its one and only long-run effect is soaring additions to the consumer's interest bill. At the same time, most importantly, it thwarts future economic growth — at the expense of current and future employment and income creation — through the structural distortions and imbalances plainly and inexorably inherent to this growth pattern.

THE FED CONUNDRUM

Rate hikes at a "measured pace" is the Fed's answer. Habitually, economists interpret rate hikes as monetary tightening. That is too simplistic. Genuine monetary tightening must essentially show in visible credit restraint. Of that, however, there is thus far not the slightest trace in the United States. See the credit numbers on the first page of this letter.

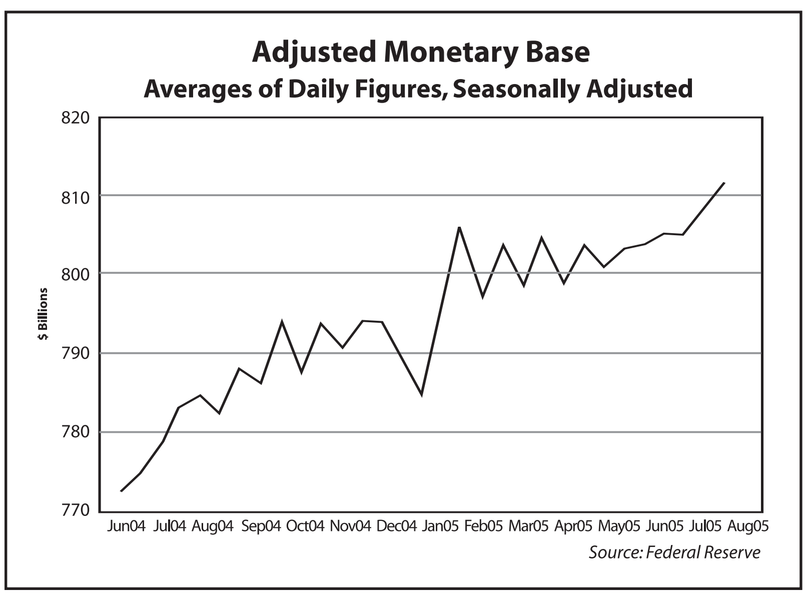
In the press releases of every Federal Open Market Committee meeting, the Fed itself describes its rate hikes as *"removal of accommodation."* Its vaguely expressed intention, with explicit reference to the Swedish economist Knut Wicksell, is to return to a "neutral" interest rate. This, as defined a century ago by Mr. Wiskell himself, is the interest rate level that neither stimulates nor restrains economic activity.

What the Fed plainly wants is continuous real GDP growth at around present rates. A significant slowdown is definitely not desired. Nor, though, is any acceleration. But with the Fed staff forecasting above-trend GDP growth, further rate hikes appear desirable to prevent this from happening. Manifestly, the Fed is assuming a very robust economy.

In principle, a central bank has two levers to exert credit restraint. Raising its short-term interest rate is one; selling Treasury bonds to squeeze the banking system's liquid reserves held at the central bank is the other.

The latter is the hard and infallible way to force the financial system to the desired credit restraint. A rigorous squeeze of bank reserves was how Paul Volcker broke America's rampant credit and price inflation in late 1979 and the following years.

This is plainly not Mr. Greenspan's desire. Despite his rate hikes, he has been generously supplying the banks with



nonborrowed reserves. On the surface, measured by the federal funds rate, the Fed is tightening. But under the surface, measured by the reserve supply, it is loosening. That is precisely what the falling long-term rates have also been saying.

We are not surprised. What the Fed must be most afraid of is a significant economic slowdown and, even more importantly, a slump of asset prices. Keep in mind that U.S. asset prices are credit driven, not savings driven. Maintaining asset prices at their presently elevated level needs continuous, rampant money and credit creation, to which the economy and its asset markets have actually become addicted to in the past few years.

In the absence of new savings, U.S. markets depend completely on persistent monetary looseness accommodating continuous heavy financial leveraging. This, however, also depends crucially on a positive yield curve.

While the Fed's present federal funds rate of 3.5%, or even 4% later in the year, may appear low against an inflation rate of 3%, entirely different considerations apply in relation to asset markets. A federal funds rate of 4%, or even a bit higher, may do little harm to economic activity. But an inverted yield curve at whatever level will prick the bond and housing bubbles.

An inverted yield curve is nothing new to the U.S. financial system. But complacent comparisons with past experience are inopportune, because something else is totally new, and that is the overriding dependence of U.S. asset markets on credit-financed carry trade.

Bill Gross of PIMCO has forecast with aplomb that in the near future U.S. Treasury note yields will decline to around 3.5%, from around 4.2% presently and 4.7% in June of last year, when the Fed started its rate hikes. To make this assumption, he must be convinced that something will prevent the Fed from going much further with its rate hikes.

Reasonably, this "something" must be a considerably weaker-than-expected economy forcing the Fed to cut rates. If this is his view, we fully share it. But we have difficulties with his conclusions concerning the Fed. It is nothing new for central banks in general, and the Greenspan Fed in particular, to have misjudged the economic situation. Lately, there has come so much macroeconomic confusion out of the Fed that anything seems possible to us.

FALLACY OF COMPOSITION

Macroeconomics is the study of effects on the economy as a whole; microeconomics is the study of effects on single firms or private households. The old economists were alert to a potentially dangerous adversity between the two perspectives, defined as a "fallacy of composition." It warns that what works for a single firm may not work for firms as a whole.

A striking and easily recognizable case of this fallacy is wage cuts. While a single firm may increase its profits cutting wages, it is inexorably self-defeating for firms as a whole. Resulting in a general decline in wage and salary income, it implicitly boomerangs for businesses as a whole by lowering consumer spending.

Overall business revenues are reduced by the same amount as wage incomes are decreased. What has prevented the corporate wage-cutting obsession in the United States from driving the economy into recession is the extraordinary willingness of the American people to substitute their shrinking wage income with higher borrowing, which, moreover, is better for corporate profits.

There are other unrecognized fallacies of composition. One is the mantra of the unalloyed benefits accruing to the U.S. economy from globalization in trade and outsourcing production overseas. Quite an array of studies has been published emphasizing these benefits. Typical to virtually all of them is the premise that what is good either for corporations or for consumers must also be good for the economy as a whole.

It is generally admitted that outsourcing production and services destroys corresponding jobs in America, but this effect is simply assumed away with the apodictic assumption that these workers will find other jobs, though probably at lower pay.

This arbitrary conjecture makes all the difference, of course, in judging the net effect of outsourcing on the economy as a whole. It goes without saying that any implicit income losses reverberate adversely on the corporate sector. Of that, though, there is never a single word. Presented statistics plainly serve to give an appearance of precision, which does not exist.

What we have read on this subject from reputed American research institutions too obviously serves the interests of Corporate America, which is notoriously obsessed with the idea that cutting labor costs is the infallible road to profit success. The trouble is that the corporations — also lacking the macroeconomic perspective — misunderstand their own interest.

The same total lack of macro perspective in these questions is certainly also at bottom why policymakers and most economists in the United States flatly fail to see any problem in nil savings, or even the outsized trade deficit.

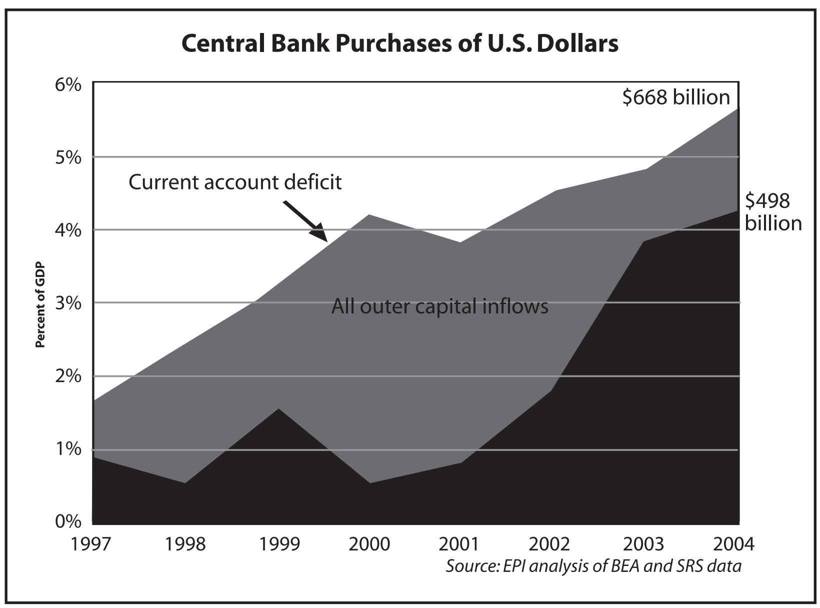
FANTASIES ABOUT A GLOBAL SAVINGS GLUT

In his testimony to Congress on July 20, 2005, Mr. Greenspan declared it quite likely that the world is currently experiencing a global savings glut. Agreeing with Ben Bernanke, he mentioned this glut as one of the factors behind the so-called interest conundrum, i.e., declining long-term rates despite rising short-term rates.

Having read a lot from the Fed's luminaries, their inability to distinguish between rampant global credit excess and a global savings glut does not surprise us. In this view, the Federal Reserve has come to the rescue of a world where excessive saving is threatening depression by eliminating savings.

Attracted by superior rates of return on U.S. assets, investors around the world have been scrambling to pour their excessive savings into direct investments, stocks, bonds and real estate in the United States, in this way financing the resulting huge U.S. trade deficit.

While this explanation may seem to make sense, there is one big snag: Not one word of it is true. First of all, in reality, private foreign investors have drastically curbed their investments in the United States. According to the Bank for International Settlement — the international organization of the world's central banks — Asian central banks financed 75% of the U.S. current account deficit in 2004.



From this chart follow two primary conclusions:

■ *First*, private capital flows into the United States have slumped. Without the massive interventions by the Asian central banks, the dollar would have collapsed long ago.

■ *Second*, the dollars with which these central banks have been buying U.S. Treasury and agency bonds have definitely nothing to do with Asian savings. Evidently, the central banks are recycling the dollars, no more, no less, which they receive from U.S. trade and capital flows. These dollars have come into the central banks' possession through their interventions in the currency markets, to prevent a rise of their currencies against the dollar.

To speak of a global savings glut as a possible cause of the surprisingly low U.S. long rates in the face of

these blatant facts is truly the height of insolence and absurdity. That this opinion comes from the leading figures of the Federal Reserve is more than shocking.

True, Asian countries have very high savings rates. For China, it is reported to be as high as 45% of disposable income. But this does not necessarily imply an existing savings surplus be lent to America. The bulk of available savings in China domestically is locked up in an even higher domestic investment ratio.

Looking at the global financial system, a straightforward fact to see is that central banks have been amassing foreign exchange reserves at an accelerating pace since the early 1970s. Rising in several large waves, their main source is plainly the soaring U.S. trade deficits.

Having no use for dollars in general, the first dollar recipients in the surplus countries sell them to their banks against their own currencies. These banks, in turn, found ready dollar buyers in firms and investors around the world, wanting to acquire direct investments or other assets in the United States, at least until 2000. Since then, though, capital inflows on private accounts into the United States have drastically receded, while U.S. trade deficits have exploded. In order to prevent a rise of their currencies against the dollar, central banks had to step in as buyers of last resort.

Apparently, it is not widely realized that this big shift in dollar recycling from private accounts to central banks essentially has far-reaching monetary implications for the participating countries and even for the world economy and world financial markets.

Buying dollars, the central banks credit the commercial banks in their country with interest-free deposits. Now, the critical point to see is that the banks, on their part, regard these deposits as their liquid reserves to be used for profitable lending or investment.

Inundated with liquid reserves by the dollar buying of their central bank, the commercial banks in these countries embark on faster credit expansion. Shifting the rising surplus of liquid reserves between them, they create credit for consumers, businesses and speculators many times the amount of the liquidity injection by the central banks.

Our focus in particular is on China. As in the United States, the resulting credit deluge is boosting components out of proportion to the whole economy. In China, however, the specific components are real estate and manufacturing investment, while in the United States, it is consumer-spending excess.

What the Asian central banks truly recycle is the U.S. credit excess. But in flooding their banking system through the dollar purchases with liquid reserves, they transplant the virus of credit excess to their own economies.

For U.S. policymakers and economists, this is a reasonable and sustainable division of labor. The U.S. economy runs on wealth creation through asset inflation with a high rate of consumption, while China and Asia run on wealth creation through saving and investment with a high rate of investment.

We are fearful of this development, because it affects more or less all industrialized countries with high wage levels. In this way, overconsuming America is force-feeding the rapid mutation of China's backward economy into a first-class manufacturing power. When China's credit and investment boom started, in 2000–01, its central bank had foreign exchange reserves in the amount of $165.4 billion. Today, they exceed $700 billion.

We are wondering what is worse for the whole world, China's further rapid manufacturing growth or a disastrous hard landing. Observing the same monetary and economic follies as in the late 1980s in Japan, we consider the second possibility highly probable.

A persistent, sharp slowdown in China's imports strikes us as ominous. The general comforting explanation is inventory liquidation. But how to explain, then, the continuous oil and commodity boom? We suspect speculation far more than economic growth as the reason.

WHAT SAVINGS?

With all the talk about a savings glut, we feel obliged to make some remarks about the subject. First, please take another look at the Wicksell quote on the first page, stating that *"the supply of real capital is limited by pure physical conditions, while the supply of money is in theory unlimited." "Supply of real capital"* is actually a synonym for available savings.

At an international conference in 1953 about savings in the modern economy, with many heavyweights in economics in attendance, the famous former chief economist of the Fed E.A. Goldenweiser gave a rare precise definition of saving. He said: *"Saving means the withdrawal of sufficient resources from the production of consumption and services to have enough for maintenance, expansion and improvement of the plant."* Then, he complained, *"that ever since Wesley Mitchell's* Business Cycles *there has been a tendency to concentrate too much on the monetary expression of economic developments, and it has become reactionary to think in physical terms."*

From the macro perspective, "saving" provides the physical resources for the production of capital goods in that consumers abstain with part of their income from consumption. Of course, this also involves money flows, but saving's decisive distinguishing feature is the partial abstention from current consumption to make real resources available for the production of capital goods.

It is ludicrous, therefore, when American economists claim that rising asset prices, increasing consumption, should by counted as saving. When we read decades ago that Mr. Greenspan, long before he became Fed chairman, had expressed precisely this view, he was once and for all finished for us as a serious economist.

CONCLUSIONS:

The world economy seems to be flooded with liquidity. But there are two diametrically different kinds of liquidity: earned liquidity and borrowed liquidity. The former comes from surplus income or savings; the latter comes from credit and debt creation.

In a country with virtually zero savings like the United States, any liquidity essentially arises from debt creation. This is really fake liquidity depending on permanent, prodigious borrowing facilities, presently the housing bubble. Once this bubble evaporates or bursts, the U.S. economy loses its chief liquidity source — with disastrous effects on asset prices.

The crucial question concerning the U.S. economy is whether it is slowing or accelerating. As explained in detail, we see a lot of fudge in the recent economic data. Our main critical consideration is that a self-sustaining recovery would absolutely require a strong rebound in business investment. But that is not in sight. On the other hand, the turnaround in the housing bubble is only a question of time. A fairly short time, we think.

The consensus expects that the U.S. economy has the "soft spot" behind it and will surprise positively. We expect shocking economic weakness. All asset prices, depending on carry trade, are in danger, including bonds.

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